



March 22, 2011

Michael Hermanson, C.P.A.  
Retirement and Benefits Administrator  
City of Tucson  
255 W. Alameda, 5<sup>th</sup> Floor  
Tucson, Arizona 85701

**Re: Application of Early Withdrawal Penalty under Internal Revenue Code  
Section 72(t) to DROP Assets Rolled into a 457 Deferred Compensation  
Plan**

Dear Mr. Hermanson:

This letter is in response to certain questions that have been raised regarding the application of the 10% penalty on early retirement plan withdrawals under section 72(t) of the Internal Revenue Code of 1986, as amended ("Code"), to amounts rolled from a deferred retirement option program ("DROP") to an eligible governmental retirement plan within the meaning of Code section 457(b) ("457 plan"), and then subsequently distributed from the 457 plan. In particular, we understand that there may be some confusion regarding the availability of the so called "age 55" exception to the 10% penalty in the above circumstance.

Below, we analyze the applicability of the age 55 exception to the Code section 72(t) penalty to distributions from a 457 plan of assets rolled into the 457 plan from a DROP.

**Authority**

As noted above, Code section 72(t) generally imposes a 10% additional tax on distributions from certain retirement plans, including Code section 401(a) qualified plans, such as DROPs, prior to a participant's attainment of age 59-1/2, unless an exception applies. The 72(t) penalty does not apply to amounts that are rolled to another eligible retirement plan pursuant to Code section 402(c) in connection with an eligible rollover distribution. Code section 72(t)(2)(A)(v) provides an exception to the 10% penalty for distributions made to a participant after he or she separates from service with the employer maintaining the distributing plan if that separation occurs during or after the year the participant attains age 55. This exception is available to any 401(a) plan

participant, and is not limited to public safety employees (or distributions directly from a defined benefit plan), as is the exception under Code section 72(t)(10).

As a result of changes made under the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"), assets may be rolled from a 401(a) plan (including a DROP) to a 457 plan, so long as the 457 plan separately accounts for the amounts. This is because, for federal tax purposes, the assets rolled into the 457 plan retain their 401(a) characteristics, including continuing to remain subject to any 72(t) penalty that may apply if the assets are distributed prior to age 59-1/2.

The Internal Revenue Service ("IRS") addressed the application of the 72(t) penalty, and its exceptions, in rollover situations in Revenue Ruling 2004-12, a copy of which is attached for your information. (See IRS Rev. Rul. 2004-12, 2004-7 I.R.B. 478 (1/29/04)). That ruling specifically addresses the ability to take in-service distributions from amounts rolled into another plan, but also generally provides guidance applicable to any distribution of rolled-in assets. In the ruling, the IRS made clear that not only would rolled-in assets remain subject to the tax rules applicable to the transferor plan, including any penalties under Code section 72(t), but also would remain subject to any *exceptions* from the early withdrawal penalty that applied to the transferor plan (See Rev. Rul. 2004-12, p. 4, "Holding"). Thus, a participant who rolled 401(a) plan assets into a 457 plan, and then sought a distribution of those assets from the 457 plan could continue to avail himself or herself of any exception to the 72(t) penalty with respect to those assets that applied at the time of distribution of the assets from the 457 plan.

### Analysis

Applying the above authority to the question at issue here, assets that are rolled from a DROP to a 457 plan would remain subject to both the Code section 72(t) penalty and any available exceptions thereto, including the age 55 exception, so long as a participant requesting a distribution of the rolled-in assets satisfied the requirements of the exception. This could occur in two circumstances. First, a DROP participant could separate from service with the employer maintaining the DROP during or after the year the participant reached age 55 and then roll his or her DROP assets to a 457 plan in which the participant is eligible to participate, either through his former employer or a new employer for which the participant works. In this instance, the participant could take a penalty-free withdrawal of the DROP assets from the 457 plan, regardless of whether the 457 plan is maintained by his former or new employer (and regardless of whether the participant performs any additional service for any employer after the initial separation from service).

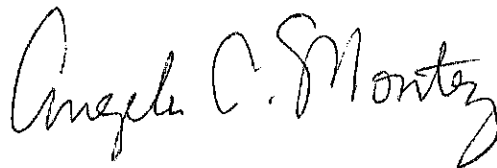
Second, a DROP participant could separate from service with the employer maintaining the DROP before the year in which the participant turned age 55 and roll the DROP assets to a 457 plan maintained by a new employer (or the participant's former employer, if the participant is re-hired by that employer). In this instance, the participant could withdraw the rolled-in assets without penalty, so long as the participant separates from service with the employer maintaining the 457 plan on or after age 55.

### **Conclusion**

For the reasons discussed above, the age 55 exception to the early withdrawal penalty under Code section 72(t) would apply to a distribution of DROP assets rolled into a 457 plan, so long as the requirements of the exception are met (i.e., both separation from service with the employer maintaining the 457 plan and commencement of distributions on or after that date) at the time of the 457 plan distribution.

We hope this information has been helpful. If you need any additional information or would like to discuss this issue further, please feel free to contact West Region Vice President, Gary Helm at (202)-997-4172.

Very truly yours,

A handwritten signature in black ink that reads "Angel C. Montez". The signature is written in a cursive, flowing style.

Managing Vice President  
and Deputy General Counsel